



This document is scheduled to be published in the Federal Register on 11/03/2011 and available online at <http://federalregister.gov/a/2011-28531>.

[4830-01-p]

## DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[REG-146537-06]

RIN: 1545-BG08

Income of Foreign Governments and International Organizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed Income Tax Regulations that provide guidance relating to the taxation of the income of foreign governments from investments in the United States under section 892 of the Internal Revenue Code of 1986 (Code). The regulations will affect foreign governments that derive income from sources within the United States.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-146537-06), Room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-146537-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW,

Washington, DC, or sent electronically, via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-146537-06).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David A. Juster, (202) 622-3850 (not a toll-free number); concerning submission of comments, contact Richard A. Hurst at [Richard.A.Hurst@irscounsel.treas.gov](mailto:Richard.A.Hurst@irscounsel.treas.gov).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget (OMB) for review and approval under OMB approval number 1545-1053 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by **[INSERT DATE 60 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §§1.892-5(a)(2)(ii)(B) and 1.892-5(a)(2)(iv). This information is required to determine if taxpayers qualify for exemption from tax under section 892. The collection of information is voluntary to obtain a benefit. The likely respondents are foreign governments.

Estimated total annual reporting burden: 975 hours.

Estimated average annual burden hours per respondent:

5 hours.

Estimated number of respondents: 195.

Estimated annual frequency of responses: 1.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## **Background**

This document contains proposed amendments to 26 CFR part 1 and to 26 CFR part 602. On June 27, 1988, temporary regulations under section 892 (TD 8211, 53 FR 24060) (1988 temporary regulations) with a cross-reference notice of proposed rulemaking (53 FR 24100) were published in the **Federal Register** to provide guidance concerning the taxation of income of foreign governments and international organizations from investments in the United States. The proposed regulations contained herein supplement the cross-referenced notice of proposed rulemaking to provide additional guidance for determining when a foreign government's investment income is exempt from U.S. taxation.

## **Explanation of Provisions**

The Treasury Department and the IRS have recently received numerous written comments on the 1988 temporary regulations. The proposed regulations are issued in response to those comments.

### **Treatment of Controlled Entities**

Section 892 exempts from U.S. income taxation certain qualified investment income derived by a foreign government. Section 1.892-2T defines the term foreign government to mean only the integral parts or controlled entities

of a foreign sovereign. The exemption from U.S. income tax under section 892 does not apply to income (1) derived from the conduct of any commercial activity, (2) received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or (3) derived from the disposition of any interest in a controlled commercial entity. Section 892(a)(2)(B) defines a controlled commercial entity as an entity owned by the foreign government that meets certain ownership or control thresholds and that is engaged in commercial activities anywhere in the world. Accordingly, an integral part of a foreign sovereign that derives income from both qualified investments and from the conduct of commercial activity is eligible to claim the section 892 exemption with respect to the income from qualified investments, but not with respect to the income derived from the conduct of commercial activity. In contrast, if a controlled entity (as defined in §1.892-2T(a)(3)) engages in commercial activities anywhere in the world, it is treated as a controlled commercial entity, and none of its income (including income from otherwise qualified investments) qualifies for exemption from tax under section 892. In addition, none of the income derived from the controlled entity (e.g., dividends), including the portion attributable to qualified investments of the controlled entity, will be eligible for the section 892 exemption. Several comments raised concerns that this so-called “all or nothing” rule represents an unnecessary administrative and operational burden for foreign governments and a trap for unwary foreign governments that inadvertently conduct a small level of commercial activity. These comments have requested that the Treasury Department and the IRS revise §1.892-5T(a) to provide for a de

minimis exception under which an entity would not be treated as a controlled commercial entity as a result of certain inadvertent commercial activity.

In response to these comments, the proposed regulations at §1.892-5(a)(2) provide that an entity will not be considered to engage in commercial activities if it conducts only inadvertent commercial activity. Commercial activity will be treated as inadvertent commercial activity only if: (1) the failure to avoid conducting the commercial activity is reasonable; (2) the commercial activity is promptly cured; and (3) certain record maintenance requirements are met. However, none of the income derived from such inadvertent commercial activity will qualify for exemption from tax under section 892.

In determining whether an entity's failure to avoid conducting a particular commercial activity is reasonable, due regard will be given to the number of commercial activities conducted during the taxable year, as well as the amount of income earned from, and assets used in, the conduct of the commercial activity in relationship to the entity's total income and assets. However, a failure to avoid conducting commercial activity will not be considered reasonable unless adequate written policies and operational procedures are in place to monitor the entity's worldwide activities. The proposed regulations include a safe harbor at §1.892-5(a)(2)(ii)(C) under which, provided that there are adequate written policies and operational procedures in place to monitor the entity's worldwide activities, the controlled entity's failure to avoid the conduct of commercial activity during a taxable year will be considered reasonable if: (1) the value of the assets used in, or held for use in, the activity does not exceed five percent of the total

value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes; and (2) the income earned by the entity from the commercial activity does not exceed five percent of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes.

Comments also requested further guidance on the duration of a determination that an entity is a controlled commercial entity. In response to these comments, the proposed regulations at §1.892-5(a)(3) provide that the determination of whether an entity is a controlled commercial entity within the meaning of section 892(a)(2)(B) will be made on an annual basis. Accordingly, an entity will not be considered a controlled commercial entity for a taxable year solely because the entity engaged in commercial activities in a prior taxable year.

#### Definition of Commercial Activity

Section 1.892-4T of the 1988 temporary regulations provides rules for determining whether income is derived from the conduct of a commercial activity, and specifically identifies certain activities that are not commercial, including certain investments, trading activities, cultural events, non-profit activities, and governmental functions. Several comments have expressed uncertainty about the applicable U.S. standard for determining when an activity will be considered a commercial activity, a non-profit activity, or governmental function for purposes of section 892 and §1.892-4T.

Section 1.892-4(d) of the proposed regulations restates the general rule adopted in the 1988 temporary regulations that, subject to certain enumerated

exceptions, all activities ordinarily conducted for the current or future production of income or gain are commercial activities. Section 1.892-4(d) of the proposed regulations further provides that only the nature of an activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is a commercial activity. This standard also applies for purposes of determining whether an activity is characterized as a non-profit activity or governmental function under §1.892-4T(c)(3) and (c)(4). In addition, §1.892-4(d) of the proposed regulations clarifies the rule in the 1988 temporary regulations by providing that an activity may be considered a commercial activity even if the activity does not constitute a trade or business for purposes of section 162 or does not constitute (or would not constitute if undertaken in the United States) the conduct of a trade or business in the United States for purposes of section 864(b).

Section 1.892-4T(c) lists certain activities that will not be considered commercial activities. One such activity is investments in financial instruments, as defined in §1.892-3T(a)(4), which, if held in the execution of governmental financial or monetary policy, are not commercial activities for purposes of section 892. Several comments have requested that the condition that financial instruments be “held in the execution of governmental financial or monetary policy” be eliminated to more closely conform the treatment of investments in financial instruments, including derivatives, with investments in physical stocks and securities, which under the 1988 temporary regulations generally are not commercial activities regardless of whether they are held in the execution of



governmental financial or monetary policy. Section 1.892-4(e)(1)(i) of the proposed regulations modifies the rules in §1.892-4T(c)(1)(i) by providing that investments in financial instruments will not be treated as commercial activities for purposes of section 892, irrespective of whether such financial instruments are held in the execution of governmental financial or monetary policy. In addition, §1.892-4(e)(1)(ii) of the proposed regulations expands the existing exception in §1.892-4T(c)(1)(ii) from commercial activity for trading of stocks, securities, and commodities to include financial instruments, without regard to whether such financial instruments are held in the execution of governmental financial or monetary policy. These revisions address only the definition of commercial activity for purposes of determining whether a government will be considered to derive income from the conduct of a commercial activity, or whether an entity will be considered to be engaged in commercial activities. They do not address whether income from activities that are not commercial activities will be exempt from tax under section 892. Pursuant to §1.892-3T(a), only income derived from investments in financial instruments held in the execution of governmental financial or monetary policy will qualify for exemption from tax under section 892.

Comments have requested clarification as to whether an entity that disposes of a United States real property interest (USRPI) as defined in section 897(c) will be deemed to be engaged in commercial activities solely by reason of this disposition. Section 897(a)(1) requires that a nonresident alien or foreign corporation take into account gain or loss from the disposition of a USRPI as if

the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. The Treasury Department and the IRS believe that an entity that only holds passive investments and is not otherwise engaged in commercial activities should not be deemed to be engaged in commercial activities solely by reason of the operation of section 897(a)(1). Accordingly, §1.892-4(e)(1)(iv) of the proposed regulations provides that a disposition, including a deemed disposition under section 897(h)(1), of a USRPI, by itself, does not constitute the conduct of a commercial activity. However, as provided in §1.892-3T(a), the income derived from the disposition of the USRPI described in section 897(c)(1)(A)(i) shall in no event qualify for the exemption from tax under section 892.

After the 1988 temporary regulations were published, section 892(a)(2)(A) was amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Public Law No. 100-647, 102 Stat. 3342 to provide that income derived from the disposition of any interest in a controlled commercial entity does not qualify for the exemption under section 892. The proposed regulations revised §1.892-5(a) to reflect the amendment of section 892 by TAMRA.

#### Treatment of Partnerships

Section 1.892-5T(d)(3) provides a general rule that commercial activities of a partnership are attributable to its general and limited partners (“partnership attribution rule”) and provides a limited exception to this rule for partners of publicly traded partnerships (PTPs). Several comments have requested that the

Treasury Department and the IRS modify the partnership attribution rule to provide that the activities of a partnership will not be attributed to a foreign government partner if that government: (i) holds a minority interest, as a limited partner, in the partnership; and (ii) has no greater rights to participate in the management and conduct of the partnership's business than would a minority shareholder in a corporation conducting the same activities as the partnership. The comments assert that the partnership attribution rule causes many controlled entities of foreign sovereigns to forego making investments in foreign partnerships or other foreign entities that do not invest in the United States out of concern that such investments might cause those controlled entities to be treated as controlled commercial entities.

In response to these comments, §1.892-5(d)(5)(iii) of the proposed regulations modifies the existing exception to the partnership attribution rule for PTP interests by providing a more general exception for limited partnership interests. Under this revised exception, an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership, including a publicly traded partnership that qualifies as a limited partnership.

For this purpose, an interest as a limited partner in a limited partnership is defined as an interest in an entity classified as a partnership for federal tax purposes if the holder of the interest does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the law of the jurisdiction in which the

partnership is organized or under the governing agreement. This definition of an interest as a limited partner in a limited partnership applies solely for purposes of this exception, and no inference is intended that the same definition would apply for any other provision of the Code making or requiring a distinction between a general partner and a limited partner.

Although the commercial activity of a limited partnership will not cause a controlled entity of a foreign sovereign limited partner meeting the requirements of the exception for limited partnerships to be engaged in commercial activities, the controlled entity partner's distributive share of partnership income attributable to such commercial activity will be considered to be derived from the conduct of commercial activity, and therefore will not be exempt from taxation under section 892. Additionally, in the case of a partnership that is a controlled commercial entity, no part of the foreign government partner's distributive share of partnership income will qualify for exemption from tax under section 892.

Comments also assert that disparity in tax treatment exists under the temporary regulations regarding foreign government trading activity described in §1.892-4T(c)(1)(ii) because trading for a foreign government's own account does not constitute a commercial activity but no similar rule applies in the case of trading done by a partnership of which a foreign government is a partner. The comments note that this disparity is not generally present in determining whether an activity is a trade or business within the United States under section 864(b). See §1.864-2(c)(2)(i) and (d)(2)(i). In response to these comments, §1.892-5(d)(5)(ii) of the proposed regulations provides that an entity that is not otherwise

engaged in commercial activities will not be considered to be engaged in commercial activities solely because it is a member of a partnership that effects transactions in stocks, bonds, other securities, commodities, or financial instruments for the partnership's own account. However, this exception does not apply in the case of a partnership that is a dealer in stocks, bonds, other securities, commodities, or financial instruments. For this purpose, whether a partnership is a dealer is determined under the principles of §1.864-2(c)(2)(iv)(a).

### **Proposed Effective/Applicability Date**

These regulations are proposed to apply on the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. For rules applicable to periods prior to the publication date, see the corresponding provisions in §§1.892-4T and 1.892-5T in the 1988 temporary regulations and in §1.892-5(a) as issued under TD 9012 (August 1, 2002).

### **Reliance on Proposed Regulations**

Taxpayers may rely on the proposed regulations until final regulations are issued.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because the proposed regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C.

chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Requests for Public Hearing**

Before the proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments, that are submitted timely to the IRS. The Treasury Department and the IRS request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

### **Drafting Information**

The principal author of these regulations is David A. Juster of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. Other personnel from the Treasury Department and the IRS participated in developing the regulations.

### **List of Subjects**

#### **26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **26 CFR Part 602**

Reporting and recordkeeping requirements.

## **Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

### **PART 1--INCOME TAX REGULATIONS**

Paragraph 1. The authority citation for parts 1 and 601 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.892-4 also issued under 26 U.S.C. 892(c). \* \* \*

Par. 2. Section 1.892-4 is added to read as follows:

#### **§1.892-4 Commercial activities.**

(a) through (c) [Reserved]. For further guidance, see §1.892-4T(a) through (c).

(d) In general. Except as provided in paragraph (e) of this section, all activities (whether conducted within or outside the United States) which are ordinarily conducted for the current or future production of income or gain are commercial activities. Only the nature of the activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is commercial in character. An activity may be considered a commercial activity even if such activity does not constitute a trade or business for purposes of section 162 or does not constitute (or would not constitute if undertaken in the United States) the conduct of a trade or business in the United States for purposes of section 864(b).

(e) Activities that are not commercial--(1) Investments--(i) In general.

Subject to the provisions of paragraphs (e)(1)(ii) and (iii) of this section, the following are not commercial activities: investments in stocks, bonds, and other securities (as defined in §1.892-3T(a)(3)); loans; investments in financial instruments (as defined in §1.892-3T(a)(4)); the holding of net leases on real property; the holding of real property which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of bank deposits in banks. Transferring securities under a loan agreement which meets the requirements of section 1058 is an investment for purposes of this paragraph (e)(1)(i). An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(ii) Trading. Effecting transactions in stocks, bonds, other securities (as defined in §1.892-3T(a)(3)), commodities, or financial instruments (as defined in §1.892-3T(a)(4)) for a foreign government's own account does not constitute a commercial activity regardless of whether such activity constitutes a trade or business for purposes of section 162 or constitutes (or would constitute if undertaken within the United States) the conduct of a trade or business in the United States for purposes of section 864(b). Such transactions are not commercial activities regardless of whether they are effected by the foreign government through its employees or through a broker, commission agent, custodian, or other independent agent and regardless of whether or not any such employee or agent has discretionary authority to make decisions in effecting the



transactions. Such transactions undertaken as a dealer (as determined under the principles of §1.864-2(c)(2)(iv)(a)), however, constitute commercial activity. For purposes of this paragraph (e)(1)(ii), the term commodities means commodities of a kind customarily dealt in on an organized commodity exchange but only if the transaction is of a kind customarily consummated at such place.

(iii) Banking, financing, etc. Investments (including loans) made by a banking, financing, or similar business constitute commercial activities, even if the income derived from such investments is not considered to be income effectively connected with the active conduct of a banking, financing, or similar business in the U.S. by reason of the application of §1.864-4(c)(5).

(iv) Disposition of a U.S. real property interest. A disposition (including a deemed disposition under section 897(h)(1)) of a U.S. real property interest (as defined in section 897(c)), by itself, does not constitute the conduct of a commercial activity. As described in §1.892-3T(a), however, gain derived from a disposition of a U.S. real property interest defined in section 897(c)(1)(A)(i) will not qualify for exemption from tax under section 892.

(2) through (5) [Reserved]. For further guidance, see §1.892-4T(c)(2) through (c)(5).

(f) Effective/applicability date. This section applies on the date the regulations are published as final regulations in the **FEDERAL REGISTER**. See §1.892-4T for the rules that apply before the date the regulations are published as final regulations in the **FEDERAL REGISTER**.

Par. 3. Section 1.892-5 is revised to read as follows:

§1.892-5 Controlled commercial entity.

(a) In general--(1) General rule and definition of term "controlled commercial entity". Under section 892(a)(2)(A)(ii) and (a)(2)(A)(iii), the exemption generally applicable to a foreign government (as defined in §1.892-2T) for income described in §1.892-3T does not apply to income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or to income derived from the disposition of any interest in a controlled commercial entity. For purposes of section 892 and the regulations thereunder, the term entity means and includes a corporation, a partnership, a trust (including a pension trust described in §1.892-2T(c)), and an estate, and the term controlled commercial entity means any entity (including a controlled entity as defined in §1.892-2T(a)(3)) engaged in commercial activities (as defined in §§1.892-4 and 1.892-4T) (whether conducted within or outside the United States) if the government--

(i) Holds (directly or indirectly) any interest in such entity which (by value or voting power) is 50 percent or more of the total of such interests in such entity, or

(ii) Holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective practical control of such entity.

(2) Inadvertent commercial activity--(i) General rule. For purposes of determining whether an entity is a controlled commercial entity for purposes of section 892(a)(2)(B) and paragraph (a)(1) of this section, an entity that conducts

only inadvertent commercial activity will not be considered to be engaged in commercial activities. However, any income derived from such inadvertent commercial activity will not qualify for exemption from tax under section 892. Commercial activity of an entity will be treated as inadvertent commercial activity only if:

(A) Failure to avoid conducting the commercial activity is reasonable as described in paragraph (a)(2)(ii) of this section;

(B) The commercial activity is promptly cured as described in paragraph (a)(2)(iii) of this section; and

(C) The record maintenance requirements described in paragraph (a)(2)(iv) of this section are met.

(ii) Reasonable failure to avoid commercial activity--(A) In general.

Subject to paragraphs (a)(2)(ii)(B) and (C) of this section, whether an entity's failure to prevent its worldwide activities from resulting in commercial activity is reasonable will be determined in light of all the facts and circumstances. Due regard will be given to the number of commercial activities conducted during the taxable year and in prior taxable years, as well as the amount of income earned from, and assets used in, the conduct of the commercial activities in relationship to the entity's total income and assets, respectively. For purposes of this paragraph (a)(2)(ii)(A) and paragraph (a)(2)(ii)(C) of this section, where a commercial activity conducted by a partnership is attributed under paragraph (d)(5)(i) of this section to an entity owning an interest in the partnership--

(1) Assets used in the conduct of the commercial activity by the partnership are treated as assets used in the conduct of commercial activity by the entity in proportion to the entity's interest in the partnership; and

(2) The entity's distributive share of the partnership's income from the conduct of the commercial activity shall be treated as income earned by the entity from the conduct of commercial activities.

(B) Continuing due diligence requirement. A failure to avoid commercial activity will not be considered reasonable unless there is continuing due diligence to prevent the entity from engaging in commercial activities within or outside the United States as evidenced by having adequate written policies and operational procedures in place to monitor the entity's worldwide activities. A failure to avoid commercial activity will not be considered reasonable if the management-level employees of the entity have not undertaken reasonable efforts to establish, follow, and enforce such written policies and operational procedures.

(C) Safe Harbor. Provided that adequate written policies and operational procedures are in place to monitor the entity's worldwide activities as required in paragraph (a)(2)(ii)(B) of this section, the entity's failure to avoid commercial activity during the taxable year will be considered reasonable if:

(1) The value of the assets used in, or held for use in, all commercial activity does not exceed five percent of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes, and

(2) The income earned by the entity from commercial activity does not exceed five percent of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes.

(iii) Cure requirement. A timely cure shall be considered to have been made if the entity discontinues the conduct of the commercial activity within 120 days of discovering the commercial activity. For example, if an entity that holds an interest as a general partner in a partnership discovers that the partnership is conducting commercial activity, the entity will satisfy the cure requirement if, within 120 days of discovering the commercial activity, the entity discontinues the conduct of the activity by divesting itself of its interest in the partnership (including by transferring its interest in the partnership to a related entity), or the partnership discontinues its conduct of commercial activity.

(iv) Record maintenance. Adequate records of each discovered commercial activity and the remedial action taken to cure that activity must be maintained. The records shall be retained so long as the contents thereof may become material in the administration of section 892.

(3) Annual determination of controlled commercial entity status. If an entity described in paragraph (a)(1)(i) or (ii) of this section engages in commercial activities at any time during a taxable year, the entity will be considered a controlled commercial entity for the entire taxable year. An entity not otherwise engaged in commercial activities during a taxable year will not be considered a controlled commercial entity for a taxable year even if the entity engaged in commercial activities in a prior taxable year.

(b) through (d)(4) [Reserved]. For further guidance, see §1.892-5T(b) through (d)(4).

(5) Partnerships--(i) General rule. Except as provided in paragraph (d)(5)(ii) or (d)(5)(iii) of this section, the commercial activities of an entity classified as a partnership for federal tax purposes will be attributable to its partners for purposes of section 892. For example, if an entity described in paragraph (a)(1)(i) or (ii) of this section holds an interest as a general partner in a partnership that is engaged in commercial activities, the partnership's commercial activities will be attributed to that entity for purposes of determining if the entity is a controlled commercial entity within the meaning of section 892(a)(2)(B) and paragraph (a) of this section.

(ii) Trading activity exception. An entity not otherwise engaged in commercial activities will not be considered to be engaged in commercial activities solely because the entity is a member of a partnership (whether domestic or foreign) that effects transactions in stocks, bonds, other securities (as defined in §1.892-3T(a)(3)), commodities (as defined in §1.892-4(e)(1)(ii)), or financial instruments (as defined in §1.892-3T(a)(4)) for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects such transactions for the account of the partnership. This exception shall not apply to any member in the case of a partnership that is a dealer in stocks, bonds, other securities, commodities, or financial instruments, as determined under the principles of §1.864-2(c)(2)(iv)(a).

(iii) Limited partner exception--(A) General rule. An entity that is not otherwise engaged in commercial activities (including, for example, performing services for a partnership as described in section 707(a) or section 707(c)) will not be deemed to be engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. Nevertheless, pursuant to sections 875, 882, and 892(a)(2)(A)(i), a foreign government member's distributive share of partnership income will not be exempt from taxation under section 892 to the extent that the partnership derived such income from the conduct of a commercial activity. For example, where a controlled entity described in §1.892-2T(a)(3) that is not otherwise engaged in commercial activities holds an interest as a limited partner in a limited partnership that is a dealer in stocks, bonds, other securities, commodities, or financial instruments in the United States, although the controlled entity partner will not be deemed to be engaged in commercial activities solely because of its interest in the limited partnership, its distributive share of partnership income derived from the partnership's activity as a dealer will not be exempt from tax under section 892 because it was derived from the conduct of a commercial activity.

(B) Interest as a limited partner in a limited partnership. Solely for purposes of paragraph (d)(5)(iii) of this section, an interest in an entity classified as a partnership for federal tax purposes shall be treated as an interest as a limited partner in a limited partnership if the holder of such interest does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the law of the

jurisdiction in which the partnership is organized or under the governing agreement. Rights to participate in the management and conduct of a partnership's business do not include consent rights in the case of extraordinary events such as admission or expulsion of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities, merger, or conversion.

(iv) Illustration. The following example illustrates the application of this paragraph (d)(5):

Example 1. K, a controlled entity of a foreign sovereign, has investments in various stocks and bonds of United States corporations and in a 20% interest in Opco, a limited liability company that is classified as a partnership for federal tax purposes. Under the governing agreement of Opco, K has the authority to participate in the management and conduct of Opco's business. Opco has investments in various stocks and bonds of United States corporations and also owns and manages an office building in New York. Because K has authority to participate in the management and conduct of Opco's business, its interest in Opco is not a limited partner interest. Therefore, K will be deemed to be engaged in commercial activities because of attribution of Opco's commercial activity, even if K does not actually make management decisions with regard to Opco's commercial activity, the operation of the office building. Accordingly, K is a controlled commercial entity, and all of its income, including its distributive share of partnership income from its interest in Opco and its income from the stocks and bonds it owns directly, will not be exempt from tax under section 892.

Example 2. The facts are the same as in Example 1, except that Opco has hired a real estate management firm to lease offices and manage the office building. Notwithstanding the fact that an independent contractor is performing the activities, Opco will still be deemed to be engaged in commercial activities. Accordingly, K is a controlled commercial entity, and all of its income, including its distributive share of partnership income from its interest in Opco and its income from the stocks and bonds it owns directly, will not be exempt from tax under section 892.

Example 3. The facts are the same as in Example 1, except that K is a member that has no right to participate in the management and conduct of Opco's business. Assume further that K is not otherwise engaged in commercial



activities. Under paragraph (d)(5)(iii) of this section, Opco's commercial activities will not be attributed to K. Accordingly, K will not be a controlled commercial entity, and its income derived from the stocks and bonds it owns directly and the portion of its distributive share of partnership income from its interest in Opco that is derived from stocks and bonds will be exempt from tax under section 892. The portion of K's distributive share of partnership income from its interest in Opco that is derived from the operation of the office building will not be exempt from tax under section 892 and §1.892-3T(a)(1).

(e) Effective/applicability date. This section applies on the date these regulations are published as final regulations in the **FEDERAL REGISTER**. See §1.892-5(a) as issued under TD 9012 (August 1, 2002) for rules that apply on or after January 14, 2002, and before the date these regulations are published as final regulations in the **FEDERAL REGISTER**. See §1.892-5T(a) for rules that apply before January 14, 2002, and §1.892-5T(b) through (d) for rules that apply before the date these regulations are published as final regulations in the **FEDERAL REGISTER**.

#### **PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 4. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.892-5 .....	1545-1053
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Steven T. Miller  
Deputy Commissioner for Services and Enforcement.

[FR Doc. 2011-28531 Filed 11/02/2011 at 8:45 am; Publication Date: 11/03/2011]